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One: California's Economic Outlook: Looking Beyond the State Budget

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Publication Date

2004-01-01

CALIFORNIA'S ECONOMIC OUTLOOK: LOOKING BEYOND THE STATE BUDGET

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California's economic outlook depends in large part on the national outlook. But it also depends, especially in the long term, on state-specific characteristics. Many argue that the hard-to-define "business climate" will be important to the long-term outlook. There was much discussion during the gubernatorial recall campaign about the budget as well as the business climate. Both are connected, of course, because a poor economy will not generate robust tax revenues. However, the state budget problem is more severe than developments in the private sector alone might suggest, for reasons discussed in another chapter of this volume.

This forecast for California includes projections through 2010. We have also incorporated for the first time the NAICS (North American Industry Classification System) definitions for California industries, which are somewhat different from the SIC (Standard Industrial Classification) categories previously used. The change, unfortunately, makes detailed sectoral analysis more difficult due to inconsistencies between the two systems.

Recent Employment Reports Show Lackluster Performance

During the year since our last long-term projection for California's economy in *California Policy Options 2003*, the state has experienced poor performance in meeting its needs for job creation. The state's budget difficulties have contributed to a declining trend in state and local government employment that is projected to continue through 2004. Job gains in the private sector have been concentrated in Southern California. Improvements are expected statewide in 2004 with the predicted stabilization of Silicon Valley's economic base, an area hard hit by the bursting of the dot.com bubble.

That being said, it is difficult to tell a story of non-farm job creation in 2004 much beyond the 1% range with perhaps growth closer to 2% per annum in 2005. Brighter areas for job gains during the next two years include transportation and warehousing, wholesale and retail trade, information services, professional and business services (beginning in 2004), education and health services (which never experienced a downturn), and leisure and hospitality services. Slower sectors are likely to be manufacturing, state and local government, and financial services. As Chart 1 illustrates, California's two recessions – in the early 1990s and the early 2000s – knocked it permanently off its earlier 3% annual growth trend in employment.

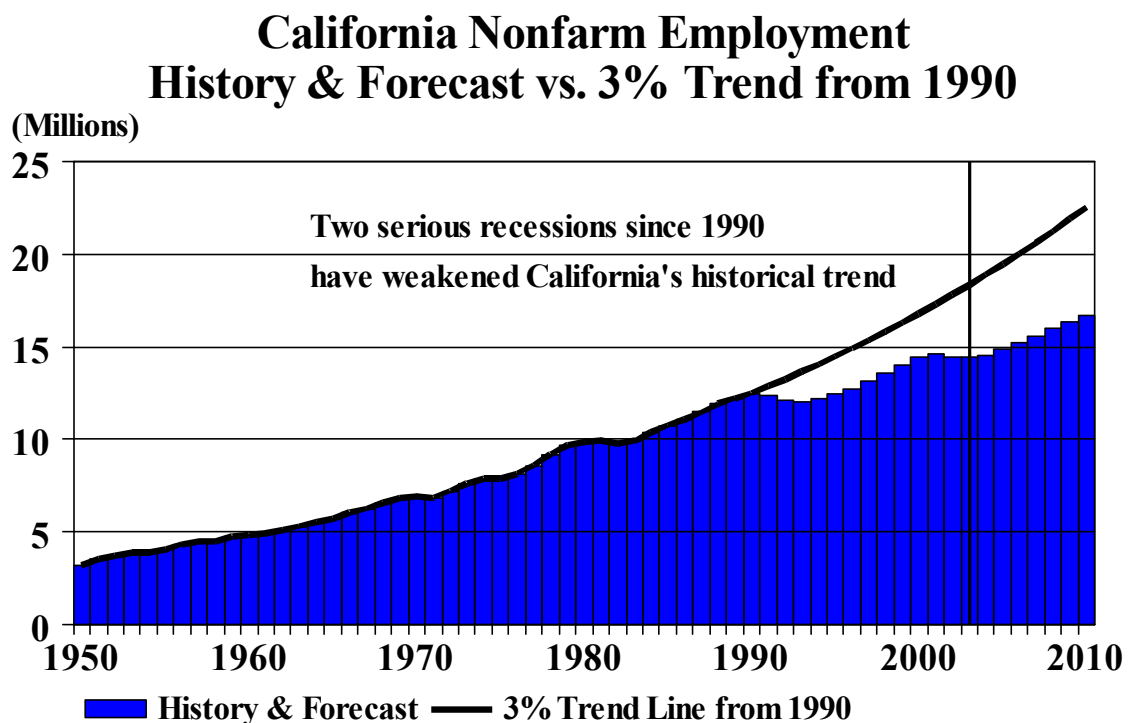
A Slow but Improving Trend for Income, Sales

The forecasts for personal income and taxable sales generally follow the overall pattern of moderate economic growth shown by employment. However, the outlook for personal income and taxable sales, particularly for 2004, do not appear to be strong enough to solve the state's near-term budget problem through economic growth. The fiscal year 2004 growth projections are weaker than the economic assumptions

underlying the fiscal year 2004 California budget approved in early August 2003. That document was based on economic assumptions made for then-Governor Davis' May revision to the budget, which incorporated an economic forecast very similar to the UCLA Anderson forecast issued in June.

Although California's residential real estate costs are the highest in the nation by virtually any measure, the demand for both new and existing homes, and for both rental and owner-occupied housing, has been very strong despite the weak economy. With an improving economy, as we are forecasting, and relatively low long-term interest rates, new home construction is projected to remain close to 200,000 units per year through 2005. At that level of production, the risk of an oversupply is low.

Chart 1



The State's Business Climate: More Than A Slow Economy?

Evaluating the State's business climate is always a tricky matter. The author has been analyzing the California economy for more than 25 years, and can remember during that time, many studies of the state's business climate that rated California well below average as a business location. For an early example, during the administration of Governor Jerry Brown in the late 1970s, a review by the Fantus Corp., a prominent location consultant in that era, found California's ranking to be dead last among the states. Yet after the recession of the early 1980s, California's economy did well.

A more recent survey conducted in 2001 by the California Business Roundtable and the California Chamber of Commerce ([Twelfth Annual Business Climate Survey](#),

January 2002, available at <http://www.cbrt.org>) also found California to have a poor climate for business. This study, based on a random sample of 400 California business leaders, rated California versus other states on six measures of business climate (individual states were not separately analyzed).

California was rated “worse than other states” by a majority of the respondents on five of the six measures: housing costs (by 81%); energy costs (by 73%); employee costs, such as workers’ compensation and insurance (by 71%); taxes (by 66%); and regulation (by 63%). Additionally, 41% rated California worse on infrastructure and transportation. While the accuracy of such surveys may be subject to dispute, the severity of the results over a very long period of time is striking. We know that business leaders tend to rank California low on business climate; we don’t know what that means about their subsequent behavior.

Interestingly, only 2% of the respondents acknowledged plans to relocate operations to another state. More ominously, 12% of companies surveyed were looking to expand in other states. Since decisions to expand and/or relocate operations are typically made in the privacy of executive offices and boardrooms, it is difficult to quantify the effect of the disenchantment measured above upon actual job losses (or job growth foregone). Until about 1990, it could be said that California employment grew appreciably faster than the nation rather consistently, in spite of a negatively perceived business climate.

While the UCLA Anderson Forecast has not conducted its own study of the California business climate, it is clear from national comparative data that California tax burdens are high and that real estate costs are also among the highest in the nation. It is also easy to point to burdensome regulatory provisions in the state and its localities. But even regulation is a two-edged sword. For example, California’s stringent environmental regulations governing air and water quality add to costs of everyday living and of doing business. But the same rules also enhance the state’s quality of life, its attractiveness to migrants, and its status as a tourist attraction. California’s high electricity costs are the product of its failed effort at deregulation of that sector.

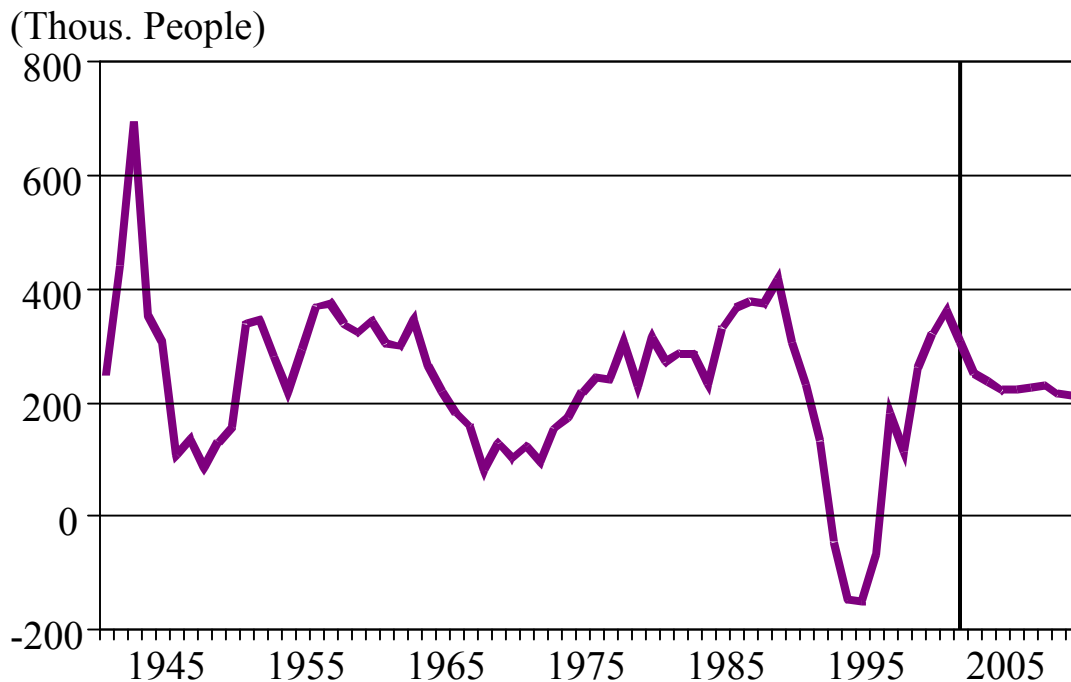
Migration Trends: A Long-Term Vote for California

One of the offsets to a poor business climate has been California’s ongoing attractiveness as a place in which to live and to work – people voting individually, with their feet. California’s economy has historically been a magnet for migrants both from other domestic states and from other nations, as Chart 2 illustrates. During the 42-year period 1960-2002, California’s population grew at an annual compound rate of 1.9%; the nation as a whole, over the same years, grew only 1.1% annually.

Even during the period since 1990, which included two major recessions and a major technology boom and bust, California’s population growth exceeded the national average by 1.4% to 1.2%. Although birth rates in California exceed death rates, net immigration has accounted for most of the growth differential between the state and the nation. California seems to have been an attractive destination.

Chart 2

California Net Migration Since 1941



With the Slowdown, Are People Leaving?

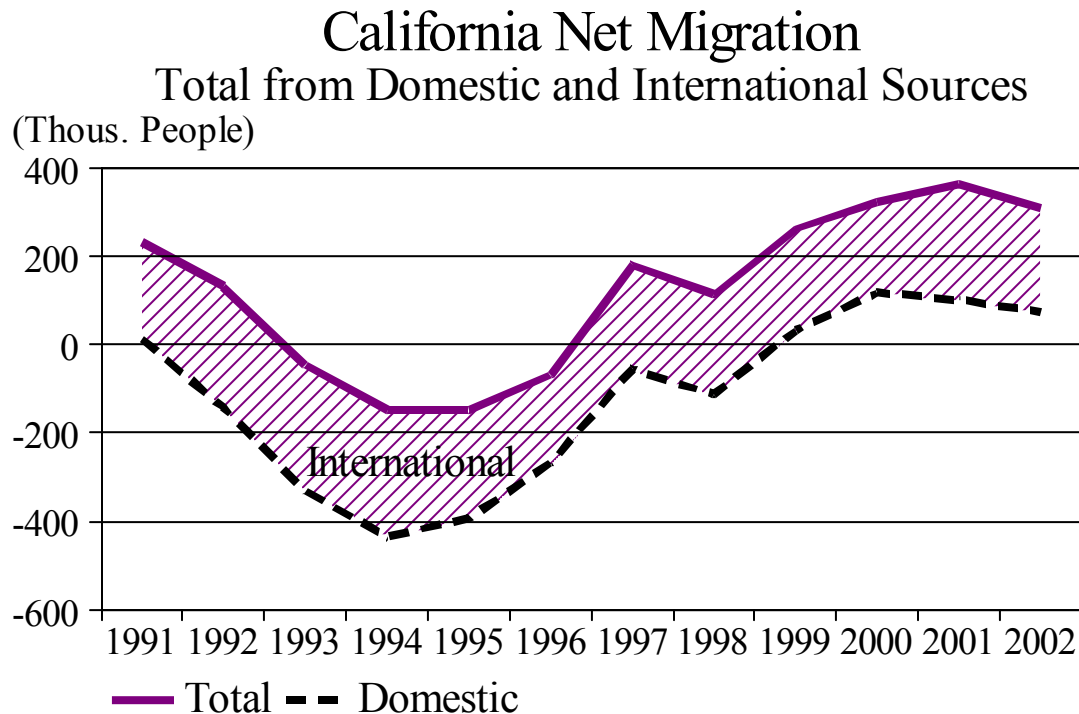
At least through mid-2002, the evidence is that California is still gaining population from net in-migration, although the domestic component (gains from other states net of losses to other states) has diminished considerably. In view of the decline in California's non-farm payroll employment since the first quarter of 2001, the continuing gain in net domestic migration in 2002 is surprising. The adjustment of domestic migration to the economic downturn of 1991-1994 in California was nearly concurrent and quite large: 1991 showed a net gain of only 14,000, and the cumulative loss from 1992-1998 was more than 1.7 million.

But international immigration to California during the 12 years (ending July 1) from 1991 through 2002 was comparatively steady, ranging from a high of 286,000 in 1994 to a low of 201,000 in 1996. To foreigners especially, California remained a magnet. It seems likely to be a magnet for foreigners in the future.

The U.S. Census Bureau recently (August, 2003) caused some confusion by finding a "late '90s exodus from California," for which Nevada and Arizona were the major destinations. This confusion stemmed from the Census Bureau's use of a 5-year interval that was quite different, economically, at the end than at the beginning. The California State Department of Finance (DoF) provides annual estimates of mobility for California's population that improved on the Census findings. The DoF data on net in-

migration, summarized in the accompanying Chart 3, showed net domestic out-migration from 1992-1998, and gains from 1999-2002.

Chart 3



In another recent study, the Census Bureau issued estimates for the year from July 2001 through June 2002 showing that nine large California cities, all in the San Francisco Bay Area, lost population during that interval. Since the region's economy was distressed, and high home prices were an additional factor causing some residents to relocate, the finding was not surprising. But it is not yet clear how many departing residents left the state, since some nearby cities gained population. Research at the DoF has shown that California continued to attract large numbers of foreign (legal) migrants even as the state was losing residents to other states during the years of 1992-1998. In fact, a recent Census study for the year 2002 showed that the state has the highest percentage of foreign-born residents, nearly 27%, of any state.

Not only is California very popular as a destination for foreign migrants, the state was also cited by a Harris Poll conducted in August 2003 as the state where the largest percentage of Americans would like to live (outside of their own state). Demographic studies and preference polls are clearly showing that California enjoys strong offsets to the negative aspects of its business climate. Whether these offsets are strong enough to overcome the negative effects of high taxes and high business costs, only time, and further study, will tell. The key point is that although it has become popular to deride California's attractiveness, there is no definitive evidence as yet that California cannot grow faster than the national economy, as it has in the past.

Evidence for California's Economy from 2003 Data

Although short-term trends do not necessarily turn into long-term trends, the data for 2003 do suggest that California has suffered from the national slump, but has not been especially hard hit when compared with other states. In contrast, in the recession of the early 1990s, California suffered a severe recession – in large part due to the contraction of aerospace – while the rest of the country experienced a relatively mild, and short-lived decline. During the current period, however, we can summarize the California economy as follows:

- Employment and unemployment continue to evidence a weak labor market, particularly in the Bay Area.
- Exports from California, at least through mid-2003, were showing improvement, due to improving trends in most of California's major trading partner nations.
- The information technology sector in the Silicon Valley area seemed to be showing improvement in sales but without a corresponding job expansion. A major problem for the Bay Area (and particularly Silicon Valley) economy going forward is a lingering high cost structure, now more moderate than during the pre-2001 boom years, but nevertheless probably the most expensive place to do business in the United States. The dynamics of Silicon Valley were recently studied in a publication by Junfu Zhang of the Public Policy Institute of California (*High-Tech Start-Ups and Industry Dynamics in Silicon Valley*, PPIC, San Francisco, 2003). The study, based on the 1990-2001 period, found that the main source of employment change in the valley was the birth and death of firms rather than movement into and out of the valley. Relocation of firms to other states was found to be a source of net job loss, but was a small proportion of the total.
- Housing construction was exhibiting improved performance by mid-2003. But even at the recent improved rate of construction, new housing is proving insufficient to meet demand at given prices and interest rates, with the result that home prices have continued to increase rapidly. Nonresidential real estate is clearly in oversupply. There was a very marked increase in office vacancy rates in San Francisco and San Jose. But the problem is much milder in Southern California.

The Longer-Term Outlook for California

Once the effects of the current slump have worn off, roughly in 2005, in our view, we expect job growth in California to return to a trend rate in the 2-2.5% annual rate, notably faster than the national trend. As Table 1 – which summarizes our long-term outlook – indicates, we see little prospect for job growth in manufacturing. But there is room for job growth in construction and many of the services.

By the end of the decade, California's overall population should be approaching 40 million people, up from just under 36 million in 2003. That growth raises familiar issues about infrastructure, education, and housing that the state has yet to address. We

expect net in-migration (from domestic and foreign sources) to continue, but as a lower fraction of the state's growing population. Taxable sales in real (inflation-corrected) dollars will not be growing at a rate exceeding population growth until the middle of the decade. With sales tax as important sources of state revenue, the budget will be tightly constrained for several years at least.

Table 1: Key California Indicators

	2000	2005	2010
Population (000s)	34,036	36,941	39,670
Net In- Migration (000s)	322	222	214
Non-farm Payroll Employment (000s)	14,488	14,899	16,711
Manufacturing Employment (000s)	1,858	1,567	1,560
Unemployment Rate (%)	4.0	6.2	5.9
Taxable Sales (Bill. of 1996\$)	405.0	393.0	472.7
Personal Income (Bill. of 1996\$)	1,005.6	1,048.6	1,249.2